DOW THEORY LETTERS INC.

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THE MARKET: On May 5 the Industrial and Rail Averages closed below their March lows on heavy volume. On the method of reading the Averages formulated by Charles H. Dow during the early 1900's, the two Averages gave the signal for a primary bear market in stocks. The fact that the two Averages broke their preceding (March) reaction lows simultaneously gave great authority to the movement. The fact that the Utility Average closed at a new low on May 4 gave an additional (but unneeded) ominous significance to the whole performance.

I did not send out a special Letter after the event because I have been preparing my subscribers for just such a bearish possibility all during 1966. In Letter 321 I pointed out that most of the other advisory services had turned unreservedly bullish during the February-March rally (which we now know was a rally in a bear market). In that same Letter I quoted William Hamilton to the effect that he had never known the majority of professionals to be right. In brief, I thought the time had come in March to invoke the theory of contrary opinion.

Even now, after the bear signal, I am flabbergasted by the stubborn optimism on the part of the great majority of investment services. Having been caught by the market in a highly bullish posture, most of the services considered it too late to "break and run," an act which would have allowed their clients to bail out with losses but with at least the greater portion of their funds intact. But Wall Street reasoned differently. "Haven't past markets always given us a chance to get out following a severe sell-off? Haven't there always been saving rallies in the past? Hasn't the bullish position been justified after each shakeout of the past 17 years? Therefore, wouldn't the odds favor the bulls after two straight-line dives which have erased a huge chunk from the Dow? And doesn't the market now resemble the situation which existed during the final frightening week of the 1962 crash?"

There is, of course, one stupendous difference between today's market and the market of 1962. The 1962 crash occurred within the framework of a continuing major bull market (and this was true also of the 1953-54 drop, the 1957-59 drop and the 1960 drop). But in the opinion of this writer the 1966 slide constitutes "something new" for this generation, the beginning of a true primary bear market. For the first time since 1937 or 1946 the bears and the shorts are on the right side of

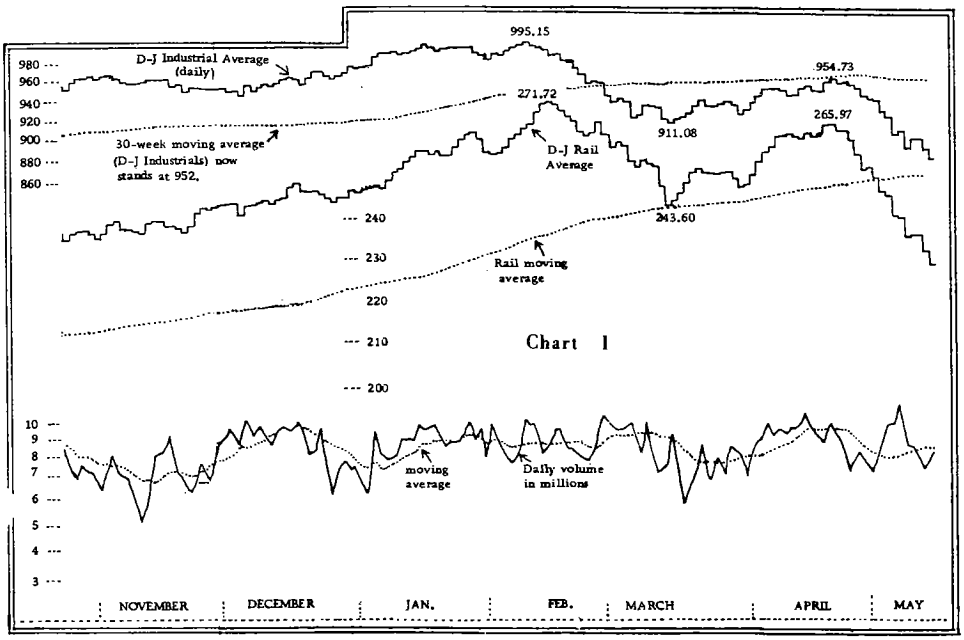
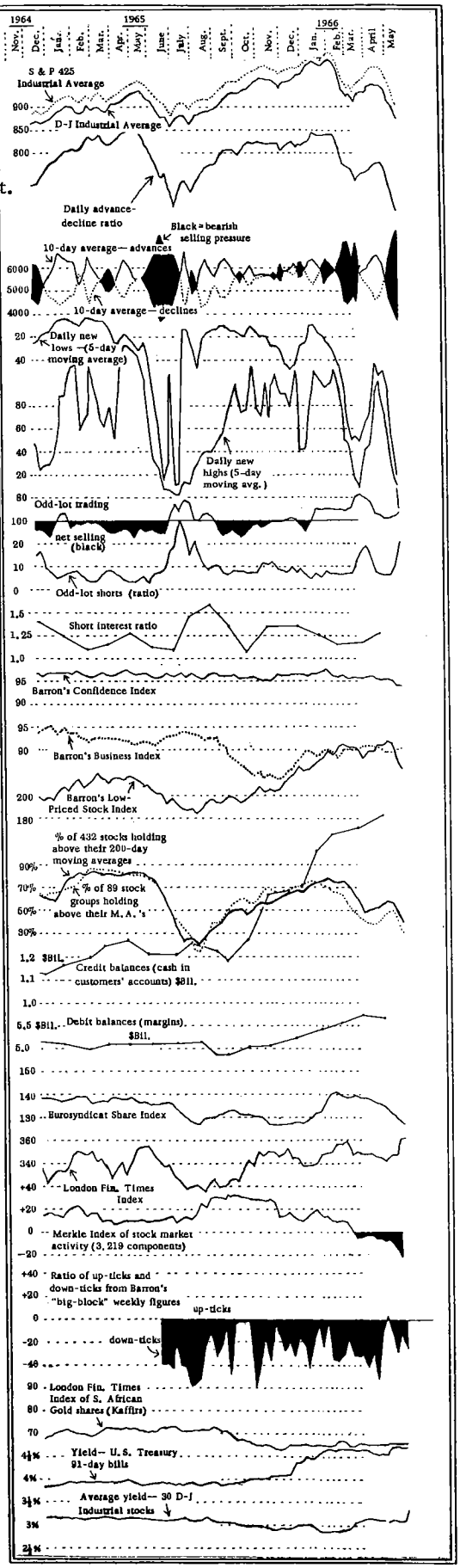


Chart I


1964
1965
1966
S & P 425 Industrial Average
D-J Industrial Average
Daily advance-decline ratio
Black = bearish selling pressure
10-day average—advances
10-day average—declines
Daily new lows—(5-day moving average)
Daily new highs (5-day moving avg.)
Odd-lot trading
Net selling (black)
Odd-lot shorts (ratio)
Short interest ratio
Barron's Confidence Index
Barron's Business Index
Barron's Low-Priced Stock Index
% of 432 stocks holding above their 200-day moving averages
% of 89 stock groups holding above their M.A.'s
Credit balances (cash in customers' accounts) $Bil.
Debit balances (margins). $Bil.
Eurosyndicat Share Index
London Fin. Times Index
Merkle Index of stock market activity (3,219 components)
Ratio of up-ticks and down-ticks from Barron's "big-block" weekly figures
up-ticks
down-ticks
London Fin. Times Index of S. African Gold shares (Kaffirs)
Yield—U.S. Treasury 91-day bills
Average yield—30 D-J Industrial stocks

the primary trend. There comes a time when the bears are dead right, when the long-term trend of the market is down, when the short sellers are correct on the big picture, and I believe that time is now.

This is a primary bear market following the greatest bull market in history. Consquently, I am hereby warning my subscribers that we are going to see much that is new, unprecedented, even unbelievable. We may have to throw out preconceived notions of what the market is "supposed" to look like, when it is "oversold," when it has gone "too far on the downside," when it is "overdue" for a correction. I believe that just as there were some eye-openers on the upside during 1949-66, there are going to be some shockers on the downside from here on.

It should be remembered that always before within memory of today's younger generation of Wall Streeters, a selling climax and a period of downside compression on big volume has led to the turn. Always before heavy odd-lot shorting and fear conditions have been the signal for the next major rise in the Averages to eventual new highs. Why was this so? The reason is that every decline since the bull market began in 1949 occurred within a major and continuing bull market. The great tidal force of the market has repeatedly bailed out the bulls over the past 17 years. In my opinion, that bail-out process is over. The bear now has the market in its panicky grip.

There will be a great temptation (particularly in the early stages of the bear market, when speculative fever still runs high and when the bear market thesis is stubbornly doubted on Wall Street) to "jump in for a late flyer on the upside." Bear markets produce rallies, often explosive rallies (these are characteristic of bear markets), but each rally in a bear market is a trap. The rallies are traps because in time (as long as the primary bear trend is in force) each rally will fizzle and die, to be followed by a new decline and a smashing of the previous lows. Buying into a primary bear market is tantamount to shorting a bull market; it is swimming against the tidal force of the market and ultimately (in the great majority of cases) it will produce disaster.

Perhaps the only time buying into a bear market is justified is following a major collapse and a wide-open crash of the 1929 or 1937 variety. Following a panic-crash there is almost always un upward movement which serves to regain around half the ground lost during the panic. We have not yet entered the true panic-crash stage of this market. When it occurs, we will discuss it (and the tactics which we will use following it)more thoroughly.

How low could this particular (the second) leg of the bear market take the Dow? The answer is that neither I nor any other man really knows. But I do know that it is a characteristic of bear legs to continue until they die in exhuastion. It is a characteristic of bear markets to make "hash" of trendlines and preconceived "support levels." Finally, it is a characteristic of primary bear movements

NOTES AND QUOTES: After many years of inflating the money supply and feeding the engines of inflation, the Federal Reserve Board is finally worried about the inflation which they helped kindle. According to the Wall Street Journal (May 6), the Board was "brooding over the economy very closely," and threatening to tighten credit further. But the stock market has again antiquated the thinking of the gentlemen on the Board. Before the year is out, the Board will be worrying about stemming deflation. Wall Street always deflates itself first, in anticipation of deflation in the economy

* * *

Meanwhile, President Johnson is unhappy because the stock market (unlike the politicians) reflects what is really going on. He is all for a new stock average to be put out by the N.Y.S.E. The price of the new average is to be around 50, and the average will be split if it ever goes above 100.

Why a new average? The answer was provided by the London Economist (April 30): "Essentially to please some segments of the financial and political communities, and particularly President Johnson. They have been most unhappy that the D-J Industrials have risen near 1000, fearing that this will make some investors think prices are very high, and have been especially displeased that the D-J index can drop 15 points or more on a sharp market break—winning black headlines and, they fear, spreading panic even though the fall is only 1½%. They want an index that will always stay fairly low in absolute terms, thus making stock prices look forever reasonable, and that will soothe investors by dropping only a modest 5 points or so even in the sharpest break." One thing you can say for the President, he is consistent. He's used gimmicks everywhere else, so why not try to change thermometers in the stock market. Who knows, maybe the patient's fever will go away if he gives him a different temperature reading.

* * *

It must come as no shock to readers to learn that the writer believes that this nation has now sunk as low in its foreign affairs as it has in its financial affairs. Perhaps two generations of living beyond its means and two generations of general fiscal immorality have paved the way for the current political morass. At any rate, this writer is disgusted by the sight of four leading U.S. construction firms working on a joint one billion dollar contract in Saigon (on a cost plus basis), I am disgusted by the sight of this nation arming every big and little country in the world, from West Germany to Turkey, from Isreal to Egypt, I am disgusted by our passive acceptance of the whole "defense establishment" (even old Eisenhower warned us about this), and the dependence upon armament production to insure prosperity in this nation. Most recently, I was shocked by Secretary of State Rusk's backing of Premier Ky, after the latter went back on his word about the August 15 election in Vietnam.

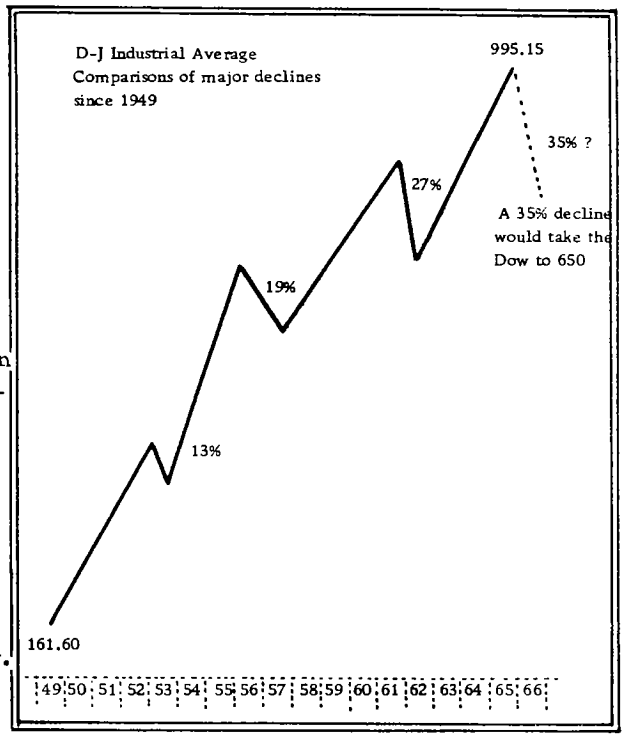
The editor of a leading magazine asked me last week what I thought would be the result of the coming bear market. I answered, "One result is going to be questions and soul-searching by the American people. The politicians have been getting away with murder for a long, long time now, and I believe that investigations are going to be the order of the day. People are going to ask questions, all sorts of questions, and its been a long time since that has happened. They're going to ask why administrations have been spending over their heads in good times and more in boom times, they're going to ask why the national debt has been allowed to sky-rocket out of all proportion, they're going to ask why we have been allowed to lose most of our gold and why the U.S. dollar has dropped so low in world esteem. They're going to ask why the wealth of the nation has been given away, and why the politicans have "rubber-stamped" President's with grandiose ideas. They're going to be asked why our Adminstration has been so secretive about what it is doing in both the political and economic sphere, they're going to be asked why a great nation has not been able to win a little war in Vietnam, why the whole nation has been allowed to mortgage its future and why the Government cannot "do something" now that the dirty laundry is beginning to show. If enough questions are asked, if enough people want to know "why," then perhaps the bear market may yet produce something of value in the midst of the pain.

* * *

This must be my week for "calling a spade a spade" so here goes on Vietnam. The latest estimate of what it is going to take in Vietnam to "win" is (1) a bombing of Hanoi-Haiphong and all infiltration routes involving Laos, Cambodia and the China-Vietnam border, (2) or a stepping of the manpower in Vietnam to 500 to 600 thousand. The first alternative could be the beginning of all-out war across Asia, perhaps including Russia and China. The second would look like the beginning of the open-ended ground war in Asia that so many military experts have warned against. Even now the cost of Vietnam is moving up to 1.5 to 2 billion dollars a month.

Bad enough? It would be if the U.S. was perhaps debt free and in the early stages of a boom. But with a bear market in progress, with Goverument receipts from corporate and individual taxes about to fall off (and they will do that during a bear market), the implications are simply unbelievable. "How can stocks go down?" an economics professor from San Diego State asked me last week. "How does this grab you?" I answered. "A tax rise in the face of a gathering recession, all in the face of a spreading war?" "That's about the way I see it at this point."

to carry further than anyone believes possible. Therefore, I urge any subscribers who may still own stocks not to attempt to ride this leg out (much less the entire bear market) to its ultimate conclusion. We simply do not know where the liquidation will stop, we do not know at what point today's (still optimistic) bids under the market will be withdrawn, bringing icy, unreasoned panic to traders, investors and funds alike.



Although primary movements are "a law unto themselves," I will try to provide a few intelligent guideposts for my subscribers. Most bear markets last 25% to 33% as long as the preceding bull market. Most bear markets wipe out at least 50% of all the gains registered by the preceding bull market. Since the bull market which started in 1949 lasted 17 years, the bear market could conceivably last four years or more. This does not mean that we cannot have some big (even extraordinary) rallies within the framework of the major bear market. We can and we will. And these will be discussed (and we will perhaps "play them") as they appear. Remember, the bigger the collapse, the bigger the ensuing (upward) correction.

I have drawn a chart (semi-logarithmic scale showing percentages) which traces the major declines of the past 17 years. Note that the tendency of each decline since 1949 has been to grow larger in percentages. Thus the 1953-54 decline produced a 13% drop in the Dow. The 1956-57 decline produced a 19% drop in the Dow. The 1962 crash wiped out 27% of the Dow. If, for the sake of argument, we now had a 35% decline in the Dow from the 995 high of February, 1966, then the Dow could go off approximately 350 points or down to 645. To round it off, we might say that the Dow could conceivably go below 700 this summer (this would constitute the completion of the second or current downward primary leg in the bear market, but it would not be the end of the entire bear market). This is, at least, one possibility which I foresee.

Secondly, it is worth noting that the Dow climbed 835 points from its 161.60 low of June 1949 to its peak of 995.15 recorded in February, 1966. If the Dow was to give back about half of all its gains during the bear market, it could go back to 578. I would therefore expect the Dow to approach at least the 578 level before this bear market dies in exhaustion on the downside. That is just a rough theoretical figure, and it will doubtless have to be revised as we near the bottom.

Question: Will this bear market be evidenced in the economy or do you think this is another 1962? Answer: I think this bear market is reflecting a coming major contraction in the economy — a contraction which will amaze everyone with its rapidity. Already we have word that Ford and GM are cutting back production. These giants are extremely sensitive to incoming sales statistics. They are cutting back now in anticipation of a slide in auto sales. We will probably see this procedure repeated in industry after industry.

Question: Won't the funds "support" the market. Answer: I don't think so. Studies made by the University of Pennsylvania suggest that the funds "tend to buy when the bulk of other investors are buying and sell when they're selling." As the bear market continues, I expect fund redemptions to gradually rise above purchases, thus producing forced liquidation by the funds. This will result in continuing pressure on the market as the public becomes disillusioned and turns in their fund shares for cash.

Question: Should I short this market? Answer: For 90% of my subscribers, the answer is "no." I have gained a lot of experience and insight into subscribers' performances on the short side, and I know that the short side tends to produce losses. The short side is always speculative, it is hard on one's nerves, it is violent, it produces sleepless nights. Rallies are always scary, and all in all I do not believe that the short side is for any but the most skilled traders or professionals. By holding cash we now own an increasing amount of purchasing power in terms of equity and merchandise. By holding gold shares we hold a hedge on the severe monetary dislocation which are almost certain to lie ahead. We should never forget that cash in a primary bear market is an investment just as stocks in a bull market are an investment. Each represents a position of long-term growth in terms of real purchasing power.

Question: What will the Government do in view of a bear market and a period of potential economic depression: Answer: The Government can do a great deal to spur the economy during a bull market, or even during a recession within a bull market. But I have serious doubts about whether the Government can do much of value during a primary bear market. After all, a great many of the excesses in the economic structure are a result of the Government's obsession with keeping the boom going. Our Government has, to a great extent, "shot its wad" during the past 17 years. Therefore, I expect the Government to try and try again, but I believe they have as much chance of turning the bear market as they have of holding back Niagara Falls. The primary trend of the stock market and the economy is bigger than any government. If informed investors really believed that our Government could reverse the tide, they would not be selling stocks now. I expect the confusion and disappointment which comes from the Government's inability to turn the tide to produce a great deal of bearishness and despair. It will also blast away the glib adages of a generation of "New Dealers," "Fair Dealers," and "Great Society" dealers. But in the end the truth will emerge. And in facts

and in truth there is strength. Perhaps the Society which will finally emerge will be purged of much of the nonsense which has been espoused for so long. If so, we will certainly come out of all of this stronger, wiser and truly greater than ever.

Question: How do you expect to survive as a service in the face of a potenially powerful and extended bear market? Answer: By telling the truth, and providing my readers with my view of what is really happening (as I have always tried to do). And by keeping my readers solvent in what promises to be a very, very trying period ahead. Remember, great fortunes have been made by those who had liquid funds available and ready near the bottom of a major primary bear market. Ultimately, we will see stocks return to a level of great value. We will buy stocks when everyone else is crushed in despair and when there is little hope of optimism on the horizon. Our buying together with the careful buying of other informed investors will help turn the tide, at a time when the bear market has discounted the worst or when it has died in exhaustion on the downside. This is how I expect to serve my subscribers during the coming bear market.

Question: Won't the forces of inflation tend to hold up common stocks? Answer: Inflation is going to end up as the biggest joke of 1966. In recent Letters I have noted that when everybody and his brother starts preparing for and worrying about inflation, you can probably write it off. Even while President Johnson and the Administration planners ponder over a tax increase to contain inflation, the stock market has turned violently down and has proceeded to discount the coming forces of deflation. In 1949 when the bull market began, the public was very solvent and everything was on a cash basis. Now that the bull market has ended, everyone and everything is mortgaged to the hilt. Just as the building up of huge sources of credit was a great impetus to the bull market after 1949, so the squeezing out of inflationary excesses (via deflation and bankruptcies) will be a powerful force on the downside from here on. Inflation during a bull market canbe very bullish. During a bear market,attempts at inflation usually prove of only fleeting importance.

Question: In Sylvia Porter's widely-read column last Monday she presented the 12 "leading indicators" and what she termed "an authoritative interpretation of what they are saying now." Of the 12 leading indicators, 10 were up and the remaining two were questionable. How can the stock market be forecasting trouble when all the leading indicators followed by Washington are bullish? Answer: One of the 12 lead indicators happens to be the stock market. In my opinion, there are certain times when you can accept this single indicator and throw out the other 11 on their ears. This is one of those times. Subscribers can mark this down. This is May, 1966. We have received a signal for a primary bear market. My bet is that by October, 1966, we won't be able to recognize this nation. We are going to see a great many important and drastic changes.

BEAR MARKET INFORMATION: The second primary leg of this bear market (which started on April 21) has taken everything with it, blue-chips, glamour stocks, utilities, low-priced stocks, the works. This is providing broad downward sweeps in breadth. Many analysts are now puzzled by the big "oversolds" which have appeared in their various advance-decline studies, and they do not see how the decline can go much further without an important upward correction.

These analysts are evidently not familiar with what can happen during a true bear market. One way of gauging the intensity of a decline is by the advance-decline ratio. So far, the second leg of this bear market has taken the A-D ratio down a bit over four points. That is a sharp drop for a bull market decline. But this is what has (and can again) occur in a real primary bear market. During the 1937 bear market, the A-D ratio dropped 14 points between August and December (a period of four months). During the 1929-32 bear market, the A-D ratio dropped 15 points between September and December, 1931 (three months). Between March and June, 1931, the A-D ratio dropped 14 points (three months). Between July and October, 1931, the A-D ratio dropped 13 points (three months). Between March and July, 1932, the A-D ratio dropped 18 points (four months).

Now remember, as gauged by the A-D ratio we have now dropped a little over 4 points since the April 21 peak. I will again warn subscribers that bears are entirely different animals from bulls. Just twenty miles south of here in Tiajuana, Mexico, the matadors do pretty well fighting the bulls. But I believe they would be torn to pieces using the same techniques against bears. Bears are simply not interested in red capes and fancy footwork.

NEWSCLIP OF THE WEEK: I have been harping about the vicious competition in the money market and its assured repercussions in the economy. The story is beginning to develop, and this dramatic clip from the May 9 New York Times gives us a glimpse into the potential 1966-67 money crisis.

GOLDS: I have said before that I believe a primary bull movement is on in golds. It is always difficult and dangerous to try to "outguess" or trade in-and-out during primary movements. The best way to capture the benefit of a primary movement is to stay invested with it until conclusion. Thus, many subscribers have written to tell me that they used to own American-South African but that they sold out for this or that reason. I have never recommended selling for any reason. Last week ASA rose to an all-time high, better that double the price at which I first recommened it. Interest is beginning to sift into some of the other golds. I recommend a policy of buying the golds and waiting. Do not trade these issues. New subscribers might purchase a package of Dome, Western Deep Levels, and President Brand.

SAVINGS ACCOUNTS FALL BY $1-BILLION

Survey Points to Shortage of Home-Building Credit

By H. ERICH HEINEMANN

An estimated decline of $1-billion in savings accounts at savings banks and savings-and-loan associations has accentuated the fear that a shortage of credit for home building may develop during 1966, a survey of government and trade association economists indicated yesterday.

The billion-dollar outflow in April of savings accounts from such institutions compares with an outflow of only about one-tenth as much in April, 1965.